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U.S. Corporate and Bank Insolvency Regimes:
An Economic Comparison and Evaluation

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I. Introduction

Firms periodically become financially insolvent, and when they do legal processes are required to resolve the claims of creditors and other stakeholders. In the U.S., unlike most other countries, two distinct legal processes exist for resolving the failures of commercial banks and other legal corporations. Underlying these two regimes are different assumptions, goals of and strategies for resolution.

The declaration and resolution of financial insolvencies at most corporations, including bank and financial holding companies, in the United States are governed by the Federal bankruptcy code.[1] However, commercial banks, insurance companies, and some other financial firms are specifically exempted from the corporate bankruptcy code.[2] Instead, the declaration and resolution of their insolvencies are governed by the provisions of the Federal Deposit Insurance Act (FDIA). The special code for banks differs significantly from the general corporate bankruptcy code in a number of important areas including:

- Objectives of bankruptcy resolution — liquidation vs. rehabilitation
- Pre-insolvency intervention

[1] The term "bankruptcy" is derived from the Italian "banca rotta" which means broken bench or bank and refers to the practice of breaking a merchant's or bank's bench in the market place when it became insolvent (Jackson, 1986, p.1). We use the term bankruptcy in its generic sense of financial distress resulting in an insolvency proceeding. Strictly speaking bankruptcy applies to corporations subject to the bankruptcy code and following the initiation of bankruptcy proceedings by a court. For banks, "bankruptcy" occurs when the bank is placed into receivership or conservatorship by its chartering or primary federal regulatory agency.

[2] In most countries in which banks are not exempted from the corporate bankruptcy code, special provisions are provided for banks in the code. A review of bank insolvency codes in many foreign countries appears in Hüpkes (2000, 2003).

- Initiation of bankruptcy
- Provisions for legal stays
- Control of the bankruptcy resolution process
    - Judicial vs. administrative procedure
    - Appointment of an administrator (receiver or conservator)
    - Function and powers of the administrator
    - Ex-post judicial review and appeal
- Priority of parties (creditors, shareholders, management) in recoveries
    - Exceptions to and effective modifications in the priorities
    - Legal standing of the parties
- Form of debtors recoveries—cash versus equity in reorganized firm
- Statutory emphasis on speed of resolution

These differences reflect perceived differences in the implications of the failures of banks and non-banks for both the immediate stakeholders and the broader economy. But the differences in these provisions may reasonably be expected to result in differences in the ex-ante behavior of banks and non-banks experiencing financial difficulties, their stakeholders, and the responsible supervisory authorities and thereby also the frequency of insolvencies and the nature, cost, efficiency, and speed of the resolution of insolvencies that do occur. The purpose of this paper is to identify and examine the important differences between corporate insolvency resolution— the U.S. Federal bankruptcy code (11 U.S.C. 101-1338)—and bank insolvency resolution— the relevant provisions of FDIA (12 U.S.C. 1821-1825)—in terms of the mechanisms involved, the objectives they seek to address, and their efficacy in addressing these objectives. This paper then discusses how each of these differences is likely to impact the financial outcome of the insolvency resolutions process.

Why Treat Banks Differently?

Banks are exempted from the general corporate bankruptcy code and subject to special provisions because they are frequently viewed as "special" and different from other firms both in their importance to the aggregate economy and in their financial fragility and vulnerability. Rightly or wrongly, banks are perceived by many to be more important to the efficient functioning of the macro economy than most other firms for a number of reasons including:

- Banks are among broadest of financial institutions and some are individually large relative to GDP.
- Bank deposits are held by a large proportion of the population, including those of limited financial means and expertise.
- Bank deposits collectively comprise the largest share of the country's money supply and are the primary medium of exchange.
- Banks have a large proportion of their liabilities in very short-term debt that can easily run.
- Bank deposits represent a significant portion of the public's most liquid assets.
- Banks are key providers of credit to households, business firms, and governments.
- Banks are central to the operation of the payments system.
- Bank assets are widely perceived to be more opaque than assets of most non-bank firms.
- Bank assets and deposits can be transferred quickly
- Banks are closely interconnected through inter-bank deposits and loans.

Evidence clearly demonstrates that the financial health of the banking industry as a whole is vital to the efficient performance of the macro economy. As a result, bank failures, and particularly large bank failures, are widely perceived to be more damaging to the economy than the failure of other firms of comparable size and to generate

particularly significant negative externalities. It is therefore argued that banks require special handling to reduce the societal cost of insolvency.[4] The potential disruptions from bank failures may be reduced by tailoring the resolution process to the unique features that make their failures particularly costly. In particular, bank insolvency procedures attempt to reduce both credit and liquidity losses to depositors and other creditors by giving the receiver broad powers, and permitting—though not necessarily guaranteeing—earlier, quicker, and more decisive actions by the delegated government regulator when insolvency threatens.

Credit losses occur when recovery values from the sale of the insolvent bank or its assets fall short of the par value of the creditor claims. Liquidity losses occur when depositors are denied immediate access to the insured or recovery value (in the case of uninsured depositors) of their accounts. If the FDIC does not immediately sell all of the deposits (insured and uninsured) to another bank or protect them in full as it generally did before 1991, the deposits may become frozen and depositor access temporarily blocked. This reduces their moneyness by effectively transforming a short-term liquid deposit into a time deposit of uncertain but longer maturity. Delaying payment of the par value of insured deposits and estimated recovery value of uninsured deposits (on demand, or as they come due in the case time deposits) is likely to produce substantial negative externalities in the markets served by the bank, in addition to the ultimately-realized credit losses (Kaufman, 2004a). The general corporate bankruptcy code in the U.S. strongly favors debtors and in its Chapter 11 proceedings, which are common for large insolvent firms, in-place managers and rehabilitation rather than liquidation. In contrast, the bank bankruptcy code favors depositors (usually the major class of bank creditors)

[4] See *inter alia* Corrigan (1983) and Hüpke (2000).

over other creditors, and encourages speedy resolution at the expense of attempts at rehabilitation. The next section of the paper compares the major provisions of both codes in the United States and traces their histories. The major differences between the two codes are summarized in table 1.

II. Comparison of the Important Provisions of the U.S. Bank and Non-bank Bankruptcy Codes

A. History

Article 1, Section 8 or the Constitution of the United States authorizes the Federal Government to "establish…uniform laws on the subject of bankruptcies." Nevertheless, Congress was unable to enact a permanent bankruptcy code until 1898.[5] When a permanent Federal bankruptcy statute was finally enacted, the act specifically exempted banks.[6] Resolution of bank insolvencies appears to have been a long-standing distinct concern. Beginning in the early 1800s, a number of bills were introduced in Congress attempting to provide special bankruptcy treatment for banks. Although not enacted, their introduction reflected widespread public concern about resolving bank failures, particularly as the banks were providing effectively all the country's currency through their note issuance. States dealt with the insolvency of state-chartered banks by suspending or not renewing their charters and appointing a receiver. For the most part, the resolution of insolvent banks appears to have been conducted similarly to the resolution of non-banks. Because banks were generally required by state law to

[5] Congress passed bankruptcy codes in 1800, 1841, and 1867 which were repealed in 1803, 1843, and 1878, respectively. The 1898 law was the first "permanent" general bankruptcy law in the U.S. (Jackson, 1986, p.1).
[6] Mark Glick, "A History of Corporate Bankruptcy", http://www.econ.utah.edu.

collateralize their note issues with specie or state and local bonds, note holders were typically treated as secured creditors.

In 1864, Congress authorized the chartering of national banks. The National Bank Act also provided for the resolution of failed national banks by specifying that

> … on becoming satisfied … that any [national bank] association has refused to pay its circulating notes … and is in default, the Comptroller [of the Currency] may forthwith appoint a receiver … under the direction of the Comptroller.

By providing for the Comptroller to declare insolvency and appoint and direct the actions of the receiver, the Act gave official recognition to the need to resolve banks differently than other firms by providing for speedy administrative action outside the slow judicial system.[7] The statutory bank receiver also could be granted powers that other receivers were ordinarily not granted.[8] The grounds for appointment of a receiver for national banks were further broadened by Congress in 1876.[9]

In 1933, the newly created FDIC was made the sole receiver for insolvent national banks and could be appointed receiver by state banking agencies for state chartered banks. This marked a departure from previous practice and bankruptcy theory by appointing a major creditor as administrator/adjudicator rather than a neutral party.[10] In addition, the Comptroller was granted the authority to appoint the FDIC as a conservator, rather than a receiver, if it preferred to attempt to rehabilitate the bank, at least temporarily, as a stand alone entity rather than liquidating or merging it quickly with a

[7] The act applied only to nationally chartered banks. A number of states adopted similar legislation for their banks, giving the state regulatory agency the authority to appoint and direct the operations of the receiver. However, a number of states continued to resolve their state-chartered banks under their state bankruptcy laws (and courts) as late as 1894 (Todd, 1994).
[8] The duties of a receiver are discussed in Upham and Lamke (1934), pp. 22-23.
[9] Upham and Lamke (1934), p. 19.
[10] Provisions in Chapter 11 that give management, hardly a disinterested party, initial control of the process, but even then the court, which has no financial interest oversees the actions and the managements plans are subject to collective approval.

solvent bank. The act expanded the Comptroller's powers to close banks, as it did not require explicit evidence of insolvency but only a need "…to conserve the assets of any bank for the benefit of the depositors and other creditors" (Walker, 1994, p.2). In 1987, the Competitive Equality Banking Act, granted the FDIC additional authority to charter a new temporary national "bridge" bank for no longer than two years[11] as an alternative to receivership or conservatorship to keep all or parts of insolvent banks operating while the bank is resolved in an orderly manner. But in both conservatorships and bridge banks, shareholder interests are terminated and senior management changed. The bank is effectively owned and operated by the FDIC or its agents.

In 1991, the FDIC Improvement Act (FDICIA) enhanced the powers of the FDIC and Federal Reserve by expanding their authority as a bank's primary federal regulator to legally close (declare insolvent) a state chartered bank under their jurisdiction and appoint the FDIC as its statutory receiver. Previously, this power rested solely with the chartering state banking agency, although the FDIC could remove insurance coverage. FDICIA also expanded and strengthened the powers of the primary federal regulations to legally close a bank beyond the finding of insufficient assets to meet its obligations, unsafe and unsound banking practices, or threatened losses that would deplete the bank's capital. Included as part of the newly enacted prompt corrective action (PCA) provisions, the new criterion requires the appropriate regulators to appoint a receiver or conservator within 90 days (allowing two 90-day extensions) of a finding that a bank's book value tangible capital has declined below the "critically undercapitalized" definition, currently set by the bank regulators at 2 percent of a bank's total assets, the minimum prescribed in the legislation. Thus, a bank need not be book-value insolvent to be placed into

[11] The legislation provides for up to three 1-year extensions.

receivership.[12] Among other things, this provision reduced the discretion of bank regulators to appoint receivers ("forbearance") which often resulted in delays at a cost of continuing, if not worsening, the insolvent bank's losses. These provisions designed to precipitate resolution before an actual event of insolvency or default mark a second important departure from bankruptcy law and provides regulators including the FDIC (though not other creditors) with a powerful tool for mitigating losses.

Lastly, in 1993, the Depositor Preference Act reordered the priority of payment of claims on insolvent banks to give priority to domestic deposits, generally those payable at the bank's domestic offices, over other types of deposits[13] and other creditors (though behind tax liabilities, unpaid wages, and administrative costs incurred by the FDIC in administering the resolution). The FDIC, standing in the shoes of insured depositors, is on an equal basis with the uninsured depositors and ahead of general creditors.

Differences with the existing general corporate bankruptcy code are further widened through an emphasis on early intervention, quick declaration of insolvency, strictly enforced creditor classes, potential speed of resolution, lack of creditor standing, limited judicial review, and administrative, rather than judicial, proceeding. The fundamentally different approaches to insolvency resolution of banks and non-banks derive from derive from differences in the goals that these procedures seek to achieve.

B. Goals of Bankruptcy

[12] If a bank is resolved at a gain to the FDIC after making all depositors and other creditors whole, the excess is paid to the old shareholders.

[13] The legal definition of "deposit" is limited by law (12 USC 1813(l)(5)(A)) and regulatory interpretation. Deposits at foreign offices are generally excluded as are some types of deposits at domestic offices, for instance International Deposit Facilities (IDF). See Curtis (2000) for a full discussion. For ease of exposition, we will refer to those deposits that qualify for deposit insurance (up to allowed limits) and under depositor preference as "domestic deposits" or simply "deposits," those deposits that do not qualify we lump under the term "foreign deposits."

The goals for corporate bankruptcy are not explicitly spelled out in the code. Different scholars have defined them in various ways. Common elements in these definitions include solutions of a collective action problem—coordinating the debt collection efforts of multiple creditors to maximize overall recovery value (Jackson, 1986); maximizing the realized value of the bankrupt firm's assets (Hüpke, 2000); distributing the assets equitably to the creditors[14] (Hüpke, 2000), if it is determined that the firm should be liquidated (U.S. Chapter 7); or restoring the firm to financial solvency by renegotiating creditor claims, if it is determined that the firm has "going concern value" (U.S. Chapter 11) and creditors would be better off than they would be in a liquidation.

In contrast, the goal of bank insolvency resolution is explicit. It is to achieve a resolution, subject to the legally-mandated claimant priorities, that "is the least costly to the deposit insurance fund of all possible methods" (12 USC 1823(c)(4)(A)(ii)). This is referred to as "least cost resolution." In pursuit of this goal, the FDIC is required to "maximize the net present value return from the sale" of assets (12 USC 1823(d)(3)(D)(i)). Because the FDIC and depositors at domestic offices presently have equal priority, achieving least cost resolution for the FDIC also achieves least cost to (domestic) depositors.

Unlike corporate bankruptcy law, where either creditors or management may initiate the process, bank resolution is initiated exogenously by regulators (including the

[14] Equitably means according to legally defined priorities and within the priority classes on a pro rata basis, taking into account valid security interests (collateral) and contractual subordination agreements (e.g subordinated debentures). Most creditors, including secured creditors (to the extent that their claims exceed the liquidated value of their collateral), fall into the "general creditor" class.

[17] Creditors may write clauses into their contracts that are triggered short of insolvency and default (e.g. due on downgrade clause), and these may in turn trigger a default precipitating the bankruptcy filing.

FDIC) according to a number of reasons specified in the code, including becoming critically undercapitalized under prompt corrective action at two percent equity to capital, or, while the bank is still book value solvent, in anticipation of book-value insolvency. No such anticipatory initiation of bankruptcy is available under the corporate bankruptcy laws.[17] However, both banks and non-bank institutions which rely on short term financing are subject to liquidity crises that may precipitate insolvency if markets believe that the institution is insolvent. Thus, while creditors cannot legally initiate insolvency procedures while an institution is still solvent (though bank regulators can), efforts by creditors to withdraw credit may achieve the same result. The downside of runs is that in response to a run and in an effort to avoid default, an institution may engage in fire sale of assets thus destroying value, though management does have the alternative of voluntary filing of bankruptcy if it wishes.[18]

Banking law traditionally considers the impact of bank resolution, not only on the bank's creditors, but also on the local economy and financial markets more broadly, while bankruptcy procedures focus narrowly on the interests of creditors, managers, and stockholders. Thus, the bank insolvency code is concerned with externalities. Under FDICIA, the FDIC may, under restrictive conditions, bypass the least cost resolution requirement if adhering to it, and imposing losses on uninsured depositors and other creditors, "would have serious adverse effects on economic conditions and financial stability and any action or assistance … would avoid or mitigate such adverse effects" (12 USC 1823(c)(4)(G)). This is referred to as the "systemic risk exemption" (Kaufman, 2004b). Likewise, in asset sales, the FDIC is directed to "…fully consider adverse

[18] Voluntary filing is possible for both banks and non-banks. It is common for large non-banks, in part because it preserves management control. It is rare for banks since management is usually replaced immediately.

economic impact…" (12 USC 1821(h)(1)). No comparable concern for the impact of insolvency resolution on third parties appears in bankruptcy law.[19]

Bank insolvency law permits keeping the insolvent bank in business temporarily through an FDIC conservatorship in order to rehabilitate and re-privatize it later. This option is rarely used and when used may be converted to a receivership. The vast majority of banks are liquidated or merged with solvent banks. Most corporate bankruptcies are also liquidations (Chapter 7), but most large bankruptcies are, at least initially, Chapter 11 administrations, at least initially under the control of existing (pre-filing) management. Thus, banking law places an emphasis on minimizing immediate losses to the FDIC and depositors through prompt initiation of legal closure and resolution primarily through liquidation; while corporate bankruptcy is more likely to weigh perceived long-term going-concern value.[20] That is for banks, even large banks, the entity per se disappears as a stand-alone entity, while for corporations that are not liquidated (those filing under Chapter 11) generally attempt to survive under their own name on a stand-alone basis.

C. Initiation of Bankruptcy

For most corporations, bankruptcy may be initiated either by a minimum number of creditors, whose claims are in default, or voluntarily by the firm itself, in anticipation

[19] The failure of corporate bankruptcy procedures to explicitly consider externalities does not necessarily reflect to an implicit belief that corporate failures do not engender significant externalities—occasional government bailouts of large corporations, protective trade policies, and recurring stories of the impact of the failure of major employers in small towns, suggests otherwise. A more likely explanation lies in the origin of corporate bankruptcy law in common law with its emphasis on parties "in interest" with legal standing (hence an emphasis on debtor and creditor and not employees, suppliers, let alone local communities). Bank insolvency procedures, in contrast, have their origins in regulatory policy with a clearer focus on markets and economic effects.

[20] In cases where an insolvent bank is quickly sold and reopens under a new name, it may be argued that little going concern value is lost

of a default. In either case, a petition is made to one of a number of federal bankruptcy courts. Court approval of the petition initiates the process. For banks, the bankruptcy is initiated by the chartering agency[21] or the institution's primary federal regulatory agency,[22] based on one or more reasons enumerated in the FDIA (12 USC 1821(c)(5)). Perhaps the most significant of these reasons, since the passage of FDICIA in 1991, is that a still book-value-solvent bank has become "critically undercapitalized," as previously defined. In addition, as also noted earlier, the regulators may appoint a receiver earlier at anytime they believe that the bank is not being operated in a safe and sound manner, and that the bank is unlikely to meet its deposit obligations. Thus, the critically undercapitalized criterion theoretically serves as a backstop intended to prevent regulators from delaying closing a bank for other prudential reasons.

D. Stays

The ability to temporarily prevent creditors from pursuing their claims (termed "stays") is central to the bankruptcy resolution process. Stays permit the resolution authority to collect and validate claims, to determine the best way to dispose of assets in an orderly, non-fire-sale manner, and to treat all like-priority creditors equally. Stays prevent creditor runs. and keep contracts in force; the counter party is bound by the contract and claims on the insolvent firm remain pending. This facilitates the coordination of creditor claims. The ability of bankruptcy courts to impose stays on most creditor claims is explicit in the corporate bankruptcy code. IN reorganizations (Chapter

[21] Comptroller of the Currency, OCC, for nationally chartered banks, state bank regulator agencies for state chartered banks and thrift institutions, and the Office of Thrift Supervision, OTS, for federal thrift institutions.
[22] OCC, the Federal Reserve, the FDIC, or the OTS.

11) the ability of courts to stay contracts is crucial for the firm to preserve productive capacity (assets) while creditor claims are being renegotiated.

Under the FDIA, the FDIC's ability to stay is limited to requesting a maximum stay of 60 days of judicial actions (law suits) to which the closed bank is a party or becomes a party.[23] The request must be honored by the courts. However, FDIA contains no general power to stay contracts. In particular, the FDIC cannot keep contracts in force while preventing their execution. Thus, unlike bankruptcy courts, the FDIC cannot stay "self-help remedies" such as liquidation of collateral, for most contracts.[24] However, the FDIC as receiver has broad powers to disaffirm or repudiate contracts (12 USC 1821(e)(1)) within "a reasonable time" (12 USC 1821(e)(2)). As they cannot compel performance under the repudiated contract, the effected counter parties must seek damages (12 USC 1821(e)(3)). Unlike the general corporate bankruptcy stay that keeps contracts in place, this procedure is more akin to the close-out mechanism found in derivatives contracts;[25] the FDIC can unilaterally terminate a contract and doing so create a claim that has the status of a general creditor. Otherwise it must make good on the contract.

Certain qualified financial contracts (e.g., derivatives master agreements, see Bergman et al, 2004) are exempt from the stays that apply to most contracts under the bankruptcy code. These derivative master agreements contain close-out provisions which when triggered allow the solvent counter party to terminate the contract (and all transactions under the master agreement), net the values, and pay the net amount due or

[23] 12 USC 1823(c)(2)(C) and Simmons (2001).
[24] Simmons (2001).
[25] See Bergman *et al* (2004).

file a claim if the net amount is owed.[26] However, these rights are not enforceable for banks under the insolvency. The FDIC has the power to prevent close-out for one business day in the case of receivership and indefinitely in the case of conservatorship or for contracts that are transferred to a bridge bank, for virtually any reason excepting non-performance (default or failure to meet collateral calls).[27] Thus, while most contracts are automatically stayed by courts in the event of a corporate bankruptcy, with the exception of qualified financial contracts, the opposite situation obtains in the event of a bank's insolvency.

E. Management of the Insolvency Process

i. Judicial versus administrative processes

Corporate bankruptcies are resolved in special federal bankruptcy courts. The proceedings are judicial in nature with each party being represented by its own lawyers. The court appoints an agent to co-ordinate the process: for a liquidation this would be a receiver and for reorganization a trustee. In Chapter 11 reorganization proceedings, the insolvent corporation's senior management is usually allowed by the court to continue operating the company and has exclusive rights to formulate a reorganization plan within 120 days.[28] Creditors may, however, petition the court to appoint an independent trustee under certain circumstances. All creditors have "standing" to be represented in the proceedings, although the dynamics of voting may lead to certain minority blocks being

[26] The benefits and disadvantages of this exemption to the usual staying of contracts during an insolvency proceeding are discussed in Bliss and Kaufman (2005).

[27] An important question concerns the status of qualified financial contracts transferred to a bridge bank or kept in force in a conservatorship. It is possible that the FDIC will effectively guarantee the values of these contracts (which will continue to fluctuate in response to changes in value of the underlying sources of risk), thus removing the element of credit risk from these contracts if they are not disavowed (and permitted to close-out) within the stipulated one business day.

[28] The bankruptcy court may, at its discretion, grant extensions of this period.

effectively frozen out.[29] Each creditor group, and in reorganizations also management and shareholders, have the right to vote to approve the plans proposed by management, receiver or trustee. Decisions undertaken during the course of the proceedings (e.g., releasing collateral to secured creditors, partial payment of claims, paying employees, post-insolvency borrowing) are taken by the receiver/trustee with the approval of the court (the judge overseeing the case). However, major decisions, such as approval of a reorganization plan, are subject to unanimous agreement by all creditor classes. If a plan is voted down, the parties continue to seek agreement possibly under a new receiver/trustee. Eventually, if the parties cannot agree the court can "cram down" the plan that it considers most equitable. Decisions undertaken by the bankruptcy court may be appealed to higher courts, although many decisions are litigated before they finally take effect.[30]

Bank insolvencies are handled in an administrative proceeding—shareholder interests are terminated and senior management is removed. The FDIC is solely in charge. As receiver or conservator, the FDIC collects information from the bank, its depositors and other creditors, determines the validity of claims and then, within the confines of the law and its own regulations, disposes of the assets and liabilities, and unilaterally makes all decisions necessary to carry out the liquidation or reorganization. No separate oversight authority—equivalent to the court/trustee relationship—exists. Furthermore, once the receiver or conservator is appointed, there is no mechanism for

[29] Usually all "creditor classes" must agree to the proposed reorganization. However, within creditor classes, voting is by majority (weighted by claim amounts). Thus, a plan may be unanimously approved by all creditor classes, but not by all creditors.

[30] A bankruptcy court typically rules on numerous intermediate matters (for instance the choice of a trustee or disposition of an assets). The parties may then choose to appeal these rulings, during which time the court may stay its own ruling until the appeals are resolved.

creditors, management, or shareholders to participate in the decision making process beyond the filing of claims and the provision of requested information.[31] In effect, claimants have no standing and very limited rights to appeal decisions before they are executed. However, some decisions of the FDIC are subject to ex post judicial review, although damages are the only available remedy. Other decisions, for instance to disallow creditor claims, are not subject to judicial review (12 USC 1821(d)(5)(E)).

F. Priorities, Collateral, and Setoffs

Both bankruptcy law and FDIA provide a list of priorities as to how creditors should be paid off (11 USC 507(a) and 12 USC 1821(d)(11)(A)). In both cases, the costs of administering the insolvency come first. These costs can be very substantial in the case of corporate insolvencies. Bris *et al* (2004) report the mean (median) ratio of total direct expenses—including attorneys', accountants' and trustee's fees—as a percentage of reported assets at time of filing to be 8.15% (2.50%) for Chapter 7 bankruptcies and 16.9% (2.00%) for Chapter 11 proceedings. The bankruptcy law goes on to list a number of unsecured creditor classes that receive favored or priority status (11 USC 507(a)). However, except for taxes (and for banks, agreements with regulators), these are likely to be of little practical importance. The large majority of unsecured corporate creditors will find themselves lumped together as general creditors.[32]

In 1993, federal banking law, however, created a large, special class of senior creditors, namely depositors, whose claims are given priority over other unsecured

[31] A bank's board of directors has the right to appeal the appointment of a receiver.
[32] A number of creditors have subordinated claims. These include subordinated debenture. However, such subordination is contractual rather than statutory. The default priority for creditors under the Bankruptcy Code is "general creditor."

general creditors.[34] Insured depositors are paid in full by the FDIC, which steps into their shoes and assumes (subrogates) their claims. Uninsured depositors and the FDIC share equally (on a pro rata basis) in any recoveries up to the amount of the deposit liabilities. Any excess recoveries are then distributed to general creditors, followed by subordinated claims, and then shareholders (including parent company equity interests). Because of depositor preference, general creditors of banks are likely to recover a smaller percentage of their claims than their counterparties at non-bank firms.

Commercial law provides mechanism for creditors to establish security interests in the property of the debtor through collateralization of their claims. If the proper legal forms have been followed, bankruptcy courts will enforce these rights. Thus, secured general creditors, while not having a higher priority claim to the assets of the bankruptcy estate, may enjoy higher recoveries than would unsecured creditors. Banking law discourages collateral arrangements on the part of a bank's depositors. In the U.S., generally only U.S. Treasury and state, and municipal governments can secure their deposits with collateral. Non-deposit creditors (including other banks and foreign depositors) have greater opportunity to secure their claims, e.g., collateral, derivative contracts, and repurchase agreements.

While corporate bankruptcy law generally frowns on offsets—the canceling of reciprocal obligations to arrive at a net amount to be owed or claimed—both the courts and the FDIC support offset for bank loans and deposits.[35] A solvent bank depositor can offset an uninsured deposit it is owed by an insolvent bank with a performing loan it

[34] A number of states had previously provided for depositor preference in their banking legislation, which applied to state-charter banks that were resolved under state laws.
[35] This is generally true in the U.S., but varies from country to country. See Bliss (2003).

owes to that bank up to an equal face value. This protects the value of the uninsured deposit and avoids having it treated as a claim subject to loss. For corporations subject to the bankruptcy code, reciprocal contracts are generally treated separately as multiple contracts and are not offset. Amounts owed by solvent counterparties must be paid as they come due, even though the same party may be owed funds from the insolvent counterparty; the solvent counterpartybecomes a general creditor for amounts it is owed and subject to losses. However, non-bank firms are less likely than banks to have reciprocal creditor/debtor contracts. Only offset of qualified financial contracts, e.g. many derivatives, under master agreements is supported for both banks and non-banks.

G. Legal certainty

The dynamics of the corporate bankruptcy process increases the uncertainties as to creditor recoveries. The straightforward priorities of payoff under bankruptcy law only apply in liquidation. The essence of corporate reorganization is that creditors participate in a renegotiation of their claims, the outcome of which, while subject to collective approval, may depend as much on bargaining power of the different claimants as on their theoretical priorities that obtain in liquidation. Furthermore, security interests may lead to apparent, if not real, redistribution between theoretically equal-priority creditors.[36] Leaving aside the possibilities that claims will be disallowed for various reasons, the distributional outcome of reorganization under bankruptcy is uncertain.

[36] Legal priority, security interests, and offset, where protected, jointly determine what a creditor is entitled to under the law, so that "violations" of priority that occur when one creditor has a security interest or a offset, are not violations of legal rights. However, the bankruptcy process with its use of class voting and the possibility that holdouts will reduce the value of the final recovery, frequently leads to dynamics where creditors give up part of their legal claim in the hopes of achieving a settlement that yields a larger recovery (smaller portion of a bigger, or at least more certain, pie).

Bank insolvencies do not suffer from this problem. Offset and collateral are usually not major issues, and depositor preference is usually adhered to.[37] Depositor preference may make foreign depositors and unsecured general creditors less certain about their recovery amounts than domestic depositors despite the fact that the closure is stated in terms of a positive minimum equity level. Because the FDIC has equal priority with (domestic) depositors and is senior to other creditors, it may view the general creditors' funds as a buffer against FDIC losses (effectively "capital"). The FDIC may therefore be less aggressive in legally closing insolvent banks that have sufficient assets to pay depositors in full and less assiduous in disposing of assets in the most efficient manner (Kaufman, 1997).

Another major uncertainty in some bank insolvencies surrounds the ability of banking regulators to extract assets out of the parent holding company for the benefit of bank depositors (including the FDIC) and general creditors. The Federal Reserve has asserted this "source of strength" doctrine, but its enforceability has been the subject of considerable litigation to date without clear resolution (the relevant cases having been settled).

H. Timeliness

Insolvency resolution timeliness has two components: the ability to initiate the process before the potential losses to debt claimants become large, and the ability to resolve the insolvency in an expeditious manner once it is initiated. Prompt closure minimizes the credit losses, while prompt resolution mitigiates both credit losses, if asset

[37] The insolvency resolution of Superior Bank is a notable exception. The FDIC negotiated with the previous owners of the failed bank to share the proceeds of litigation against the banks auditors, Ernst and Young. See Johnson (2005).

values are declining, and liquidity losses to creditors who have their funds tied up in the insolvent firm.

As was noted earlier, there is no mechanism for non-bank corporate creditors to preemptively precipitate a bankruptcy proceeding so as to limit their losses. Instead, they must await an event of default that permits them a basis for petitioning the court to place the firm into bankruptcy. Managers can and sometimes do file for bankruptcy, usually Chapter 11, in anticipation of an actual default. However, in such a voluntary action the managers may not always be acting solely in the creditor's interests. On the other hand, bank regulators have broad powers to legally close a bank on the suspicion that it may get into financial trouble and a positive requirement to close it before it becomes book value insolvent. However, when a bank becomes financially distressed, bank book values are likely to exceed market or economic values by increasing amounts and regulators are frequently unaware of the true economic solvency of a bank until it is well and truly economically insolvent. Nonetheless, evidence suggests that in most instances banks are resolved with proportionally smaller losses relative to combined depositor and other creditor claims than to creditors in corporate bankruptcies, both before and after the establishment of the FDIC.[38,39]

Once initiated, the FDIC as receiver can move with self-determined speed and has done so in the past. The bank may be sold immediately, generally over the first weekend, in part or whole, converted into a temporary bridge bank, or liquidated more slowly

[38] Bris *et al* (2004) and Kaufman (1994).
[39] It is rare, however, that general creditors recover anything in a bank insolvency. However, the evidence is derived from recent banks failures which have invariably been small, with few non-domestic deposit claims and usually structurally simple (NextBank and Superior were small but complex banks). It would be hazardous to extrapolate from this evidence how a large complex bank resolution might compare with a comparable-size corporate reorganization (since most large corporations initially filed under Chapter 11)..

through time. Current practice, however, is to keep the bank in receivership while the assets are sold.[40] Because of the prompt payment of insured depositors at par and the potential for early payment of the expected recovery value of uninsured deposits, liquidity issues are potentially separate from the time in receivership.

FDIA recognizes the special character of bank deposit claims that because of their liquidity they serve as money. Thus, the FDIA requires that "payment of the insured deposits…shall be made by the Corporation [FDIC] as soon as possible" (12 USC 1821(f)) and authorizes the FDIC " to settle all uninsured and unsecured claims with a final settlement payment" based on average past recovery values in order "to maintain essential liquidity and to prevent financial disruption" (12 USC 1821(d)(4)(B)). The FDIC also has the authority to make advance dividend payments to claimants based on its estimates of recovery values for the bank being resolved. Like the prompt payment of insured deposits, advanced dividends on uninsured deposits minimize liquidity losses. However, advanced dividends are likely to be less than par value, so that the uninsured claimants will suffer credit losses, at least initially.[41]

In the absence of advanced dividends, the FDIC pays out "traditional" dividends on remaining claims as it liquidates assets, the proceeds of which are shared first by the FDIC and the uninsured depositors, followed by general creditors (including foreign depositors), and finally shareholders. These dividends, which depend on the progress of the resolution, may be spread over a number of years. Since the introduction of FDICIA

[40] The ability of the FDIC to sell the bank quickly may have been constrained by the least cost resolution of FDICIA, which makes it difficult to arrange whole bank transfers at a loss to the FDIC. Purchase and assumption, which used to be common, now appears to be rare. The key question remains how quickly and cost-effectively a major bank failure might be resolved. Recent small bank evidence suggests that the FDIC does not usually liquidate assets quickly.

[41] A history of attempts to deal with liquidity losses at resolution of bank insolvencies in the U.S. appears in Kaufman (2004a).

in 1991, the FDIC has paid advanced dividends progressively less frequently and has relied more on regular dividends (Kaufman, 2004a). This has caused liquidity losses, but as the involved banks have been reasonably small, the adverse effects have been local and not severe.

While insured depositors continue made whole quickly, and for small banks these represent the majority of claims, for the remaining creditors and other stake holders waits can be substantial.[42] In practice, there is substantial variation around the average length of time the bank is in receivership and the timeliness of bank insolvency resolution appears to have changed over time.

In corporate bankruptcy there is no immediate resolution, and the average length of time the firm is in Chapter 7 or 11 may be long and variable (See Bris *et al*, 2004). Creditor liquidity in corporate bankruptcy is tied more closely to the time spent in receivership than in bank insolvency as there are only limited arrangements for payments to creditors before proceeds are received from the sale of assets. Thus, the final resolution of banks may be faster than for non-banks, but need not be, but, at least for domestic depositors, usually provides some recovery prior to the final resolution.[43]

I. Multiple Jurisdictions

[42] Of the 24 bank insolvencies since 2000:

- One bank was sold immediately
- Four banks have paid final dividends (2 in less than 6 months, two after more than 2 years).
- The remaining 19 banks (apparently) remain unresolved after periods ranging from 6 to 50 months (the mean is 28 months).
- All 19 have paid intermediate dividends. The mean time from closure to first dividend was 4.4 months, and the mean dividend amount was 54%.

[43] The ability of the FDIC to sell the bank quickly may have been constrained by the least cost resolution of FDICIA, which makes it difficult to arrange whole bank transfers at a loss to the FDIC.

Both bankruptcy and bank insolvency laws and procedures reflect an implicit assumption that a single venue (court or administrative proceeding) is resolving a single firm. This is true for most small firms and many small banks. However, this single firm/single venue breaks down for multinational firms and financial institutions.[44] Multinational firms, be they banks or non-banks, are subject to multiple jurisdictions when they fail. There are two approaches to this problem: to treat the firm as a single entity and to have one court take the lead in guiding the resolution (the universal approach) or for each jurisdiction to conduct separate proceedings using the assets under its control for the benefit of local creditors (the territorial approach).

Recent revisions to the U.S. bankruptcy laws (Bankruptcy Abuse Prevention and Consumer Protection Act of 2005) have adopted many of the provisions of the United Nations Commission on International Trade Law (UNCITRAL) model law for governing international insolvencies. However, both the UNCITRAL model law and the U.S. legislation specifically exempt banks. The U.S. approach to bank insolvency is territorial with respect to foreign banks than have offices in the U.S., while universalist with respect to domestic banks. Thus, if a foreign bank with U.S. activities fails, as did BCCI in 1991, U.S. regulators would seize any assets in the U.S. and use those to satisfy domestic creditors (including uninsured claimants) before passing any surplus to foreign courts for distribution to foreign creditors. However, if a U.S. bank with foreign offices were to fail, the FDIC would assert claims over the world-wide assets of the bank and seek to use those to pay off creditors (under depositor preference rules which give priority to domestic depositors).[45]

[44] See Bliss (2005) for a full discussion.
[45] It is not clear whether foreign courts would go along with such an effort.

Multiple jurisdictions also arise because, particularly in the U.S., many banks are embedded in bank or financial holding companies. Bank and financial holding companies are non-banks subject to the bankruptcy code while their subsidiary banks are subject to FDIA. Where the bank insolvency leads to failure of the parent holding company as is frequently the case, different parts of the firm are simultaneous being resolved in different venues. These simultaneous resolutions are occasionally adversarial particualry when there are assets in the holding company.

Conflicts arise when the FDIC expects to suffer losses in the resolution of the bank and seeks to extract assets from the holding company, necessarily putting it in conflict with the creditors of the holding company. U.S. law provides little structure for handling bank/holding company insolvency proceedings. If the holding company has been induced to enter into an agreement to recapitalize the subsidiary bank, such agreement has priority over general creditors. Under the "source of strength" doctrine the Federal Reserve, regulator of bank and financial holding companies, asserts an obligation of the holding company to support the subsidiary bank, even if it closed. The legal support for this claim is ambiguous and efforts to decide the matter in court have been inconclusive.[46]

III. Analysis

The differences between (non-bank) bankruptcy and bank insolvency processes can be summarized as a coordinated negotiation among creditors and managers

[46] Important cases are MCorp and BNEC. The former involved attempts by regulators to enforce asset transfers from the holding company to the subsidiary banks after insolvency proceedings had begun; the latter involved pre-insolvency asset transfers that were challenged as fraudulent by the bankruptcy trustee. Both cases were settled before the underlying source of strength claims was ruled on.

supervised by a neutral court aimed at protecting the rights of all parties on the one hand and an administrative process conducted by the FDIC (itself a major creditor), with limited participation by other parties, designed for speed (to mitigate both credit and liquidity losses) and to minimize the costs to the FDIC (deposit insurance fund) on the other. Insofar as these differences are intended to achieve different objectives they make sense if they are necessary and effective in achieving their desired ends.

The prompt payment of insured depositors claims has gone a long way to reducing the liquidity losses of most depositors. This has not reduced runs, but it has mitigated the effects of runs. Frequently, when banks are perceived to be distressed, uninsured depositors leave, but banks simply replace uninsured with insured deposits. Then when the bank fails most of the depositors are insured and made whole immediately. When the deposit insurer pays off the insured deposits and makes advanced dividends to uninsured claimants and then subrogates their claims, liquidity is provided. Since the deposit insurer does not have the same liquidity needs as other creditors, the substitution of creditors achieves the desired result. This process, however, does not require that the deposit insurer manage the insolvency, only that the insurer has funds available to make the statutorily required payments.

The granting of insolvency administration powers to the deposit insurer in an administrative process has two advantages: it avoids the costs and delays of litigation, and, where assets are insufficient to cover depositor claims, it aligns the interests of the administrator with the goal of maximizing the realized value of the bank's assets.[47] Because depositor preference places uninsured (domestic) deposits on an equal footing

[47] This assumes that the FDIC's objective is to minimize losses to the insurance fund, as is statutorily mandated.

with the FDIC with its subrogated claim, the FDIC's interests are aligned with those of the uninsured depositors and so there is no inherent conflict of interest between the administrator and those creditors that can reasonably hope to realize something from the insolvency administration.

Since most bank insolvencies to date are small banks with few non-deposit liabilities, the current structure has worked reasonably well. The reluctance to pay advanced dividends and the time taken in paying regular partial dividends to uninsured depositors means that liquidity provision is not as rapid as the law permits, however the experience of these creditors is far better than could be expected under bankruptcy where payments may be delayed until final resolution.

However, when the insolvent bank has substantial amounts of non-deposit creditors conflicts of interest may arise. This is apt to be the case with the very largest, systemically important banks, as well as with some smaller specialized banks. Where non-deposit creditors are large, they can reasonably expect to receive some recovery, but the process is entirely controlled by the senior creditor. Bankruptcy law, for all its complexity, is designed to ensure that all creditors have representation and the process is supervised by a neutral party (the court) to ensure that all creditors' interests are protected. Bank insolvency law is explicitly designed to protect the interest of the senior creditor by giving that creditor control, limiting oversight, and mandating least cost (to the senior creditor) resolution. Where depositor claims are likely to be satisfied, that is where non-deposit liabilities are large, no structural mechanisms exists for aligning the FDIC's interests with those of the remaining creditors, and no neutral party is interposed in the process to protect the interests of the other creditors. As previously mentioned the

incentive problem created by large amounts of non-deposit claims also may undermine the prompt closure provisions of FDIA, by allowing the bank regulators to gamble for resurrection at the expense of non-deposit creditors.

III. Conclusions

The differences between bank and non-bank insolvency proceedings in the U.S. have significant and in some aspects fundamental differences. Central to these are the use of a judicial process overseen by a neutral court for non-banks and an administrative process overseen by the FDIC for banks. These differences reflect different goals: for non-banks to protect creditors' rights, for banks to mitigate credit losses through prompt closure and liquidity losses through rapid resolution. Both processes, in practice fail to fully achieve their goals. For non-banks, the control granted managers' in Chapter 11 has created dynamics that undermine creditors' ability to realize their claims. This leads to managers and junior creditors extracting concessions that they would not obtain if senior creditor controlled the process.

The banks insolvency has been fairly successful in reducing losses in insolvency by closing banks earlier than is the case for non-banks. Nonetheless, the fact that almost all banks that are closed are economically insolvent, imposing total losses on general creditor and some losses on uninsured depositors is evidence that the objectives of prompt corrective action are not entirely met. It may, however, be argued that this failure is due to problems inherent in (necessary) reliance on book value triggers and that prompt

corrective action is material in reducing the losses.[48] The second area that bank insolvency resolution has fallen somewhat short is in reducing liquidity losses. The means for providing liquidity available in the law have not always, particularly recently, been applied.

The limited evidence that we have of the effectiveness of bank insolvencies and somewhat greater evidence on non-bank insolvencies is not entirely informative of a comparison. Most bank insolvencies have been small, while we have ample evidence of major non-bank insolvencies. Several studies have been done of losses to the FDIC (and equivalently depositors) from bank insolvencies, and anecdotal evidence exists as to timeliness of bank insolvency though no systematic evidence has been published. No published evidence (apparently) exists as to losses to non-depositor bank creditors, costs of administration, or asset recovery rates.

The critical question from a policy perspective is how bank insolvency procedures, which do reasonably well for small, structurally simple banks (few non-deposit liabilities), will fare when a major bank with substantial non-deposit liabilities, complex, non-traditional on- and off-balance sheet activities, and international activities fails. We have already witness the adversarial effects that arise from decoupling bank holding company and embedded bank insolvencies. The examples to date of banks involved in complex financial products (albeit small) show that complexity undermines rapid resolution.[49]

[48] Evidence of before- and after-FDICIA losses in bank resolutions is somewhat ambiguous; see Kaufman (200?).

[49] NextBank and superior are examples. Both cases have led to long delays and extensive litigation that demonstrate that bank resolution is not always free of the delays and costs associated with non-bank insolvency.

Table 1:
Selected Differences between the Corporate and Banking Bankruptcy Codes

Provision	C**orporate**	**Banking**
Objective	Maximize value of firm as "going concern" or liquidation	Minimize loss to FDIC (least cost resolution)
Exception to Objective	None	Systemic risk exemption, stability of financial system
Pre-failure intervention	By negotiation (Voluntary)	Statutory (prompt corrective action) (Involuntary)
Initiation (Declaration of Insolvency)	Major creditors and/or management petition bankruptcy court	Chartering or primary federal regulator
Creditor stays	General (explicit)	Less general, major exception is insured depositors, (implicit)
Receiver/Trustee	Appointed by court	FDIC (statutory)
Management of entity during bankruptcy	Court appointed management (trustee; in Chapter 11 usually the existing management initially)	FDIC
Supervisor of receiver/trustee	Bankruptcy Court	FDIC
Structure of Process	Judicial	Administrative
Deviation from Priorities	Negotiated among stakeholders	Systemic risk exemption only
Legal standing of creditors	By statute	None
Creditor Representation	Representative Process	None
Creditor Approval	Unanimous agreement	None
Timeliness of bankruptcy initiation	Requires default event	Can act pre-emptively
Final word	Bankruptcy Court	FDIC
Judicial Review and appeal	Ex-ante	Ex-post
Legal Certainty	Weak	Strong
Right of offset	Variable	Strong
Creditor payment form	Liquidation—cash Reorganization—securities	Cash
Legal and administrative expenses	High	Low
Shareholder Interests	Small and subject to negotiation	Terminated

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